

# Fashioning a new Korean model out of the crisis: the rebuilding of institutional capabilities

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This article argues that the Korean model, while being remarkably effective in its early decades, had outgrown its institutional shell by the 1990s, and was in need of the reforms that were hastened by the 1997 financial crisis. The article is based on an analysis of the IMF rescue package that was introduced in two stages in December 1997. It can be demonstrated that it represented three agendas at work—a conventional IMF agenda, a US trade and investment opening agenda, as well as a Korean-imposed institutional reform agenda. It is this latter reform agenda that has shaped the restructuring initiatives taken in Korea in 1998.

## 1. Introduction

The financial meltdown in East Asia in 1997–98 had dramatic effects not only on the countries of the region itself, but on the scholarly debates over the sources and limits of the ‘East Asian Miracle’ model of development as well.<sup>1</sup> The achievements of the fast-growing East Asian economies are not in question: as Joseph Stiglitz put it, the East Asian Miracle was real.<sup>2</sup> But the methods used by the East Asians in constructing this miracle were cast in a pitiless spotlight through the financial chain-reactions of 1997, and, in many cases, were found wanting. Positions adopted before the crisis have thus had to be revised.

The case of Korea is of particular interest, in that it grew so fast and so effectively up to 1997, and then fell so heavily. In the trauma of November and December 1997, the Korean economy, which had grown to become the eleventh largest in the world, was reduced to a wreck, tossed on the seas of international finance. Practices which had

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<sup>1</sup> See World Bank (1993) for the ‘East Asian Miracle’ analysis, which has sparked a wide debate, and effectively put an end to the polarisation between those analysing East Asian success in terms of neoclassical market analysis, and those analysing it in terms of institutional capabilities.

<sup>2</sup> See Stiglitz (1998) for a review, and Radelet and Sachs (1997) for an extended defence of the East Asian Miracle process.

seemed smart before the crisis, like extended debt leveraging in order to expand businesses, came to be seen as folly when external conditions turned adverse, and repayment obligations could not be met.

Every crisis is pregnant with opportunity, as the Chinese characters *wei ji* tell us. The Korean case is of particular interest in the way that the country has recovered from the worst effects, relatively quickly, and by the middle of 1998 was rebuilding a new version of a 'Korean model'—turning the crisis to its own advantage by reforming the political-economic structures, which were in fact long overdue for reform but which could not be tampered with in the absence of a major crisis. The key to the transformation lies in the role played by the twin IMF agreements of December 1997. While many saw these agreements as yet another case of heavy-handed IMF intervention looking to dampen economic activity at the very time that it needed to be revived, and many also saw them as instruments of US foreign and economic policy, few have interpreted the agreements as embodying the interests of institutional reform in Korea. Yet the case is strong that this is indeed the role they have played, providing the *external sanction* needed to drive reform. This paper seeks to substantiate this proposition, by reference to the IMF agreements themselves, their concordance with earlier Korean reform initiatives, and to the subsequent reform and restructuring efforts mounted under their mantle in 1998 in Korea.

The year 1997 is certainly not the first time that Korea has fallen into the arms of the IMF. In 1971, just ten years after the unleashing of the export-oriented growth model, and again in 1980–83, at the stormy conclusion to the crash-through programme of heavy and chemical industrialisation, the pattern was strikingly similar. A period of breakneck expansion of industrial capacity and output, fuelling exports and capitalised by borrowed funds, ended in an overheated blow-up as external conditions turned adverse and made interest and capital repayments problematic. In each case IMF intervention calmed things down, stabilised the economy, and domestic 'rationalisation' cleaned out the weaker corporate players, preparing the system for its next period of breakneck expansion.<sup>1</sup> It is a remarkably simple, remarkably effective model of accelerated economic development. The catch is that there has to be some institution to salvage the wreckage when the process gets overheated—otherwise the foreign borrowings that drive it will dry up and capital investment will henceforth be dependent on national savings.<sup>2</sup>

The 'old' Korean model, that died on 30 November 1997 and was finally buried on 24 December 1997, was built on three foundations:

- strong industrial conglomerates (*chaebol*) able to penetrate new markets and industrial sectors;
- a financial system that channelled capital, chiefly through foreign borrowings, to the *chaebol* ('policy loans'); and
- strong 'pilot agencies' to set the lead for investment in new sectors and the standards for judging corporate performance (e.g., export levels).

This model must be counted as one of the most successful 'engines' of accelerated industrial development ever devised and put into practice. Its strengths were the capacity to move rapidly into new sectors—first into labour-intensive industries in the 1960s; then

<sup>1</sup> See Park and Song (1997) and Johnston, Darbar and Echeverria (1997) for analyses of Korea's capital liberalisation and earlier experiences of crisis. Loriaux (1997) provides a more general discussion.

<sup>2</sup> These are not inconsiderable in Korea (as in Japan and other East Asian countries such as Singapore)—but they would not on their own provide the leverage for the accelerated growth that Korea has enjoyed. See Cho (1994) for an overview of savings and investment in the Korean development model.

into capital-intensive heavy and chemical industries in the 1970s; and then into knowledge-intensive industries in the 1980s—and to mobilise the resources necessary to do so. Its weaknesses were, first, its extreme dependence on foreign borrowing, and hence vulnerability to externally generated downturns. Second, the dependence on strong and large industrial firms turned into a fetter as these firms grew ever larger and more powerful. In the 1980s, and increasingly in the 1990s, they became a political force that was in many ways out of control. The concentration engendered by the model threatened to choke off all other forms of development and initiative in the Korean economy. Only something drastic—like a major crisis—could loosen the grip that the *chaebol* came to exercise over the economy. Third, the role of state agencies in directing development, combined with financial non-transparency, could and did lead to excessive cronyism and outright bribery and corruption, as revealed in the case of Hanbo Steel (discussed below). The strong ‘envelope’ of regulatory controls and restrictions also became increasingly incompatible with the decision-making imperatives of nimble, high-technology firms competing in international marketplaces, and its dismantling proceeded in a jerky, on-off process of deregulation followed by re-regulation without a clear goal or sense of purpose.

The ‘old’ Korean model, like its counterpart in Japan in the 1930s (which it resembles in many striking ways), threatened to become a political force beyond the control of existing state agencies and newly created democratic institutions. It was unstoppable, or, rather, could be stopped only by a major crisis. Hence the tendency among the political and business elite in Korea, particularly within the circles grouped around the new president, Kim Dae-Jung, to regard the 1997–98 meltdown as a ‘blessing in disguise’.

## **2. The unravelling of the Korean model in 1997**

By the crisis year 1997, Korea’s rapid industrial development through borrowed capital was nearing the end of its fourth decade. The government-induced ‘policy loans’, which had made so much sense in the years of heavily regulated finance, made less and less sense as the financial system was slowly liberalised and deregulated.<sup>1</sup> Indeed, the continuation of strong policy direction over investment and open market sourcing of capital borrowings made for an explosive mix in which cronyism and corruption could—and did—flourish. Nonetheless, an external crisis that no one foresaw brought the system down. How it happened is a matter of great interest, since it also affects how the new model is being fashioned, in 1998, out of the ruins of the old.

The Korean crisis of 1997 had many elements, but there were at core three processes whose interactions catapulted the country to the brink of insolvency. There was a debt default crisis, triggered by adverse external circumstances that made it difficult for companies and banks to service their loans. Korea has always lived with high debt levels, making it vulnerable to external downturns. But this crisis saw company collapses imposing huge losses on domestic banks, which in turn created a liquidity crisis as letters of credit could not or would not be honoured. The liquidity crisis forced further companies and banks into difficulties, so that foreign banks and investors started to withdraw, and external credit-rating agencies downgraded Korean stocks and bonds. This created a run on the currency, which had been gently devaluing after two years of appreciating along with the US dollar.

<sup>1</sup> See Woo (1991) for the definitive account of the role of finance and its regulation in Korea’s development, and Cumings (1997) for the most recent and comprehensive account of this experience in the wider political setting of Korea’s development.

All these factors came together in a downward vicious spiral in November and December of 1997. The more the exchange rate fell, the more companies had to hedge their foreign operations, and withhold their foreign earnings, putting further pressure on the exchange rate, and exacerbating the debt repayment problems (since the external debts were largely denominated in US dollars). In this way, a crisis feeds on itself and amplifies processes that would normally be self-correcting.<sup>1</sup>

How did Korean corporations get themselves into a level of indebtedness that made them critically vulnerable to any economic downturn or demands for capital redemption from creditor banks? This is easily answered. They simply continued to do what they had always done. High levels of debt-to-equity ratios, and high levels of cross-divisional debt guarantees by one affiliate supporting fellow affiliates, have always been a part of the 'Korean model'. In the 1990s, it was merely being practised on a larger and riskier scale, and by smaller and less experienced *chaebol*, anxious to become players in the international Big League.

Across the board, Korea's top 30 *chaebol* were leveraged to the extent of debt exceeding shareholders' equity by nearly 4 times (actually, a ratio of 3.87)—compared with the situation in other countries, such as Taiwan (0.85), Japan (2.0) and the US (1.6). With hindsight, such a degree of leveraging might be dismissed as foolish. Yet it sustained Korea's rapid growth in the 1980s and 1990s very nicely, particularly in the case of the top five *chaebol*, which fluctuated around this average (Hyundai being the most daring, at a ratio of 4.4, and Samsung the most conservative, with a ratio of 'only' 2.7—as shown in Table 1). The high ratio reflects not imprudence on the part of the top *chaebol*, but the structure of capital institutions in the country, with banks supplying much more developmental capital than equity markets.<sup>2</sup> So the problem was not the high debt-equity ratios themselves, but the abuse of this system by some of the smaller and medium-sized *chaebol*, who were anxious to grow and move up the ladder by whatever means available.<sup>3</sup>

There was a further twist to these practices, in the form of 'cross-group debt-guarantees'. Mutual guarantees were a secret weapon of Korea's *chaebol*, enabling them to expand rapidly and diversify with minimal collateral. But in the hands of weaker and inexperienced players they became a trap that could ensnare the entire group when one marginal affiliate stumbled—with Kia and Halla being two of the most spectacular cases of this effect at work. Table 1 reveals that Halla's debt guarantees amounted to 1.38 times its equity base; the situation was even worse for Jinro, whose debt guarantees amounted to 4.6 times its equity base.

A catastrophic series of corporate bankruptcies in 1997 revealed how vulnerable firms with these kinds of debt-equity ratios and cross-divisional debt guarantees could be. Hanbo Steel folded in January 1997, with debts totalling more than 5 trillion won (\$5.85 billion)—the largest collapse in Korea's history. But this was only the beginning. Other affiliates of the Hanbo group, which had been forced to act as guarantors of Hanbo Steel's debts, also collapsed, effectively bringing down the entire group, Korea's 14th largest

<sup>1</sup> For further details, see Mathews (1998) for analysis of the debt repatriation demands that triggered the crisis in Korea, based on capital flow data provided by the Bank for International Settlements and the International Institute for Finance.

<sup>2</sup> The Korean debt-equity ratios are far from unknown in advanced industrial countries. In the case of leveraged buyouts, where debt is involved far more than shareholder equity, such ratios would be considered conservative.

<sup>3</sup> Worst offenders in this regard were Hanbo, whose collapse in January 1997 signalled the start of the souring of the Korean miracle, and other *chaebol* such as Halla, Kia, Jinro and New Core.

**Table 1.** Debt-equity and debt-asset ratios and cross-group debt guarantees for 30 largest chaebol, 1997

Company	Debt-asset ratio (top 20)	Debt-equity ratio (%)	Debt guarantee (trillion won)	Guarantee- equity ratio (%)	No. of subsidiaries
Hyundai	376	436.7	4.04	41.1	57
Samsung	206	267.1	1.92	13.6	80
LG	313	346.5	1.29	15.5	49
Daewoo	337	339.5	3.74	47.8	32
Sunkyong	320	383.8	0.71	15.1	46
Sangyong	297	409.4	2.20	68.4	25
Hanjin (Korean Air)	619	555.8	0.84	39.4	24
Kia*	418	519.0	2.09	91.3	28
Hanwha	619	751.4	1.77	142.6	31
Lotte	179	192.2	0.56	20.8	30
Kumbo	465	481.8	1.01	78.9	26
Halla*	2,930	2065.4	0.42	138.4	18
Dong-Ah	320	354.7	1.04	75.3	19
Doosan	625	688.2	0.43	52.9	25
Daelim	344	423.3	1.19	106.7	21
Hansol	290	291.9	0.62	50.5	23
Hyusung	315	370.1	0.15	16.9	18
Dongkuk	190	218.4	0.48	42.6	17
Jinro*	2,532	3075.0	0.51	462.0	24
Kolon	350	318.0	0.59	64.1	24
Kohap	—	590.5	0.42	78.8	—
Dongbu	—	251.5	0.58	61.2	—
Tongyang	—	307.8	0.56	85.0	—
Haitai*	—	658.5	0.21	45.6	—
New Core*	—	1225.6	0.36	172.5	—
Anam	—	478.5	1.62	349.4	—
Hanil	—	576.8	0.17	44.6	—
Keoppyung	—	347.6	1.86	353.2	—
Miwon	—	416.9	0.64	144.2	—
Shinho	—	489.3	1.12	290.2	—
Totals	—	386.7 (av.)	33.15	47.04	—

\*Company under court protection.

Sources: Bank of Korea for debt-asset ratios for top 20; Korean Fair Trade Commission for debt-equity ratios, debt guarantees, and subsidiaries.

*chaebol*.<sup>1</sup> Why the banks had continued to lend to such a poor risk subsequently became clear: they were being bribed by Hanbo's founder, Chung Tae Soo, to do so. Chung, it turned out, had been indicted twice before for bribery, but somehow had managed to stay in business. Eventually he was forced to default because even the banks, despite the bribes, refused to go on lending to him, and demanded his removal from the company's management. Eventually the bribery scandals spread, reaching even into the President's

<sup>1</sup> Hanbo Steel and Hanbo Construction were badly affected by a downturn in the building industry in Korea, but the default was actually on debt raised to build a huge steel mill. In 1988, Hanbo Steel had raised 2.7 trillion won to build the mill, when it had an equity base of 90 billion won, giving it a debt to equity ratio of 30 to 1. Costs ran well over the original estimate, and banks were continually pressed for more funds, rising by 1998 to more than 5 trillion won, against the company's equity base in January of 224 billion won, a debt to equity ratio of 22 to 1.

office, thus effectively tying the hands of the government at the very moment when strong leadership was called for to stem the mounting crisis.

Korea's crisis, therefore, had elements that were imported from the wider crises of the region, and in particular from the difficulties facing banks in Japan and Hong Kong who had lent short to Korean firms and merchant banks, but it also had elements that were entirely self-generated, such as the *chaebol* collapses of 1997 and government inactivity due to mounting bribery scandals. The system was in considerable disarray at the time of the November and December financial crisis which saw the intervention of the IMF.

### 3. The IMF agreements of December 1997

There were three agendas at work in the twin IMF agreements signed with Korea on 5 and 24 December 1997. First, a conventional IMF agenda called for monetary rectitude, some financial austerity, and fiscal responsibility. Macroeconomic targets were set, and austerity measures demanded. While the targets themselves were relatively pointless, the austerity measures raised interest rates and tightened liquidity at a time when it was already severely contracting. The IMF argued that this was necessary to restore 'health' to the banking sector. While this is no doubt true, it tightened an economic noose that was already squeezing healthy businesses.

The second component was a conspicuous American agenda to open up the Korean economy to foreign investment. This was contained in the 'restructuring and reform measures' clauses of the IMF agreement. It called for accounting standards and disclosure rules to be strengthened to meet international practice and audit standards; for acceleration of the schedule allowing foreign entry into the Korean financial sector, including allowing foreign firms to establish bank subsidiaries and brokerage houses by mid-1998; for liberalising foreign investment in the Korean stock market, increasing the ceiling on aggregate foreign ownership in firms from 26% to 50% by the end of 1997 and to 55% by the end of 1998; for allowing foreign banks to purchase equity in Korean domestic banks in excess of the 4% limit requiring supervisory authority approval; for allowing foreign investors to purchase, without restriction, domestic Korean money market instruments and corporate bonds; and for reducing restrictions on foreign direct investment in Korean industrial and other firms through simplification of procedures.<sup>1</sup> These matters are not normally the subject of IMF agreements, and they reflect a clear concern by the American sponsors of the IMF, who wanted a substantial opening of the Korean market to US investors as *quid pro quo* for the bail-out.<sup>2</sup>

The Koreans fought these provisions, but not very strenuously, partly because there is a strong lobby within Korea that supports such liberalisation and opening up of the Korean economy (in the name of imposing discipline on domestic firms), and partly because there existed a Korean agenda which had to find a way into the negotiations. Reaching a *quid pro quo* with the American agenda was the point of leverage. The Korean side in the negotiations knew exactly what it was doing and made use of the extraordinary opportunity created by the IMF intervention to transform the Korean 'model' from a developmental system to a more mature system. The Korean-instigated reforms (which had not

<sup>1</sup> These requirements have subsequently been enacted by the Koreans, in successive reforms implemented by the new Kim Dae-Jung administration.

<sup>2</sup> That these matters constitute a US agenda is not hard to prove, the US Congress, and US officials such as the Special Trade Representative, having repeatedly called for these very measures to be implemented, without success, until the financial crisis enabled them to incorporate these points into the IMF agreement.

been part of any comparable IMF agreement with a country in trouble) cover matters such as: corporate governance and structure (e.g., transparency of corporate balance sheets and full implementation of international accounting standards for Korean *chaebol*, and consolidated financial statements for business conglomerates); reducing the levels of mutual debt repayment guarantees between affiliates within a single business group; easing restrictions in the labour market over redundancies (to enable businesses to move from one industry to another); opening the way to corporate bankruptcy procedures; and, above all, reform of the financial sector, including separation of the Bank of Korea from the Ministry of Finance and the creation of a new office for the supervision of all financial institutions. Taken as a group, these constitute a quite remarkable set of structural reforms, all incorporated into the agreement at the instigation of the Korean side.<sup>1</sup>

#### **4. Reforming the Korean financial sector**

While international attention has been focused on Korea's renegotiation of external debts and the floating of a successful government-backed bond issue, the real reform process has continued quietly at home. Central to the reform of the Korean model has been a restructuring and 're-engineering' of the financial sector, and in particular an overhaul of its regulatory and supervisory processes. This is in clear recognition of the damage inflicted by the dismantling of previous regulatory controls (e.g., over capital inflows) and by the inadequacy of supervisory structures. The reforms have been very much in line with those mandated by the IMF agreements, which can be interpreted to mean that there has been an opening up to foreign intervention (the US agenda) complemented by complete overhaul of the regulatory structures (the Korean agenda).

First, the worst affected and worst performing financial institutions were quickly closed. The greedy merchant banks that borrowed short and lent long were singled out for disciplinary action. As part of the December IMF Accords, a total of 14 merchant banks were placed in provisional liquidation by the Kim Young Sam administration. At the beginning of February, the new Kim Dae-Jung government announced that ten of these would actually be shut down and arrangements made to provide some protection for their creditors. To minimise the impact on creditors—i.e., the companies that borrowed from these banks—the government set up at the beginning of February a 'bridging bank' that would temporarily assume some of the debt held by the suspended banks until they could be liquidated, merged, or sold. The remaining 20 of the 30 merchant banks were given until the end of February to devise plans to stay afloat. Subsequently, in July, five commercial banks were ordered to close their doors definitively, under orders from the newly established Financial Supervisory Commission (to be discussed below).

The second element in the restructuring involved clearly separating the Bank of Korea (the central bank) from the Ministry of Finance and Economics, and stripping both of supervisory functions. The Bank of Korea is being consolidated as the principal instrument of the country's monetary policy, in charge of setting prime interest rates.<sup>2</sup> Such a restructuring is critical to breaking the nexus between monetary policy and supervision of financial institutions, which was one of the factors allowing situations like the Hanbo scandal to flourish. The independence of the Bank of Korea is thus protected

<sup>1</sup> According to my informants in the Ministry of Finance during extensive discussions in January 1998.

<sup>2</sup> The restructured Bank is to consist of a Monetary Board as the supreme decision-making organ of the central banking system and an executive body headed by the Governor of the Bank of Korea, who will concurrently hold the position as Chair of the Monetary Board.

and reinforced, while its supervisory powers are diminished and transferred. The Ministry of Finance and Economy is to retain the authority over macroeconomic and broad financial policy and license the establishment of financial institutions.

The third element involves restructuring completely the mechanisms for supervision of financial institutions, and the creation of a powerful new office for such a purpose, to be located within a strengthened prime minister's office. The new consolidated institution is to consist of a Financial Supervisory Board (FSB) and Financial Supervisory Agency (FSA) together with a Securities and Futures Trade Commission.<sup>1</sup> The Financial Supervisory Agency is to be the special juridical body responsible for inspecting, auditing and sanctioning financial institutions. Until the new structures are established, an interim Financial Services Commission has been established and began operating in early April 1998 to act as financial watchdog and to direct reforms of the industrial conglomerates.<sup>2</sup> The Commission revealed that it had teeth when in July 1998, only three months after its establishment, it ordered the closure of five non-viable commercial banks, and gave seven further banks 'conditional approvals' requiring them to undergo substantial restructuring, including replacement of senior management.<sup>3</sup>

Finally, the non-performing loans that lie at the heart of the Korean debt crisis, and continued through 1998 to cripple the operations of the banking sector, have been addressed through the creation of the Korea Asset Management Corporation (KAMC), which is empowered to purchase the assets of shaky institutions (such as collateralised non-performing loans) and sell them off to domestic and foreign bidders. This institution, like similar bodies created for similar purposes in Thailand, Indonesia and Malaysia, is modelled not on a Japanese institution but on the US Resolution Trust Corporation, which played an important role in resolving the savings and loan crisis of the 1980s.<sup>4</sup>

The implications of these changes are likely to be profound. The FSB and FSA are likely to become central players in monitoring the future health of the financial sector in Korea and preventing any repetition of the suicidal short-term borrowings that characterised the activities of the newly established and deregulated merchant banks in the mid-1990s and that helped trigger the 1997 crisis. The clarification of the role of the Bank of Korea, and its separation from any supervisory function, is likely to diminish the scope for bribery and corruption. The KAMC has moved rapidly to cleanse the bad debt problems, in striking contrast with the painfully slow progress made in solving a comparable problem in Japan. The restructuring carries the full mandate of the IMF, and indeed would not have been politically feasible in Korea without its intervention, but it has been driven by the Korean government itself, under the fresh administration of Kim Dae-Jung.

<sup>1</sup> The Board is to be responsible for the promulgation and amendment of supervisory rules, licensing of business activities and operations of the financial institutions, other than their establishment.

<sup>2</sup> The head of the interim Commission is Lee Hun-Jai, a former mandarin of the financial ministry who fell foul of his masters and then spent a decade working in the private sector. He has emerged as a powerful enforcer of reform in the financial sector, complementing the equally tough role played by Park Tae-Joon in reforming the industrial sector.

<sup>3</sup> The five banks ordered to close or merge were the three national banks, Daedong, Dongnam and Donghwa, and the two regional banks Kyunggi and Chungchong. The seven institutions given 'conditional approvals' were the Korea Exchange Bank, Cho Hung, Commercial Bank of Korea, Hanil, the Peace Bank of Korea, Kangwon and Chungbuk.

<sup>4</sup> The US Resolution Trust Corporation, established in the mid-1980s, was empowered to conduct audits of suspect savings and loan bodies, shut down insolvent bodies, and sell off their loans and underlying collateral as repackaged securities ('securitisation of debt') or through public auctions, normally at considerable discounts to their face value.



### 5. Reforming the industrial sector: reining in the *chaebol*

Underpinning the Korean crisis lay the expansionary practices of the mid-sized *chaebol*, extending their activities through debts that far exceeded their equity base or their capacity to repay. While these practices had been exposed and denounced by many before, both within and outside Korea, they went on unchecked—with the disastrous results of 1997, and the bankruptcies of Hanbo, Sammi, Jinro, Halla and many others. So reform of *chaebol* practices has been near the top of the political agenda for a long time in Korea, but until 1997 the necessary will or sense of crisis was lacking.<sup>1</sup> The IMF intervention and agreements, and then the election of Kim Dae-Jung as president on 18 December, changed all that. The IMF Accords contained several clauses explicitly targeted at reforming the structures and operations of the *chaebol*, as mentioned. However, it was up to the Korean Government (and Kim Dae-Jung's transition team in the first instance) to act on them and drive through the changes—something that had eluded previous administrations. The President-elect showed that he meant business by calling a meeting of the country's top five business leaders—the heads of the leading *chaebol*—in January 1998, only three weeks after his election and six weeks before his inauguration, to secure their agreement to a binding five-point undertaking. This historic compact between the *chaebol* leaders and the President-elect committed them to:

- producing consolidated balance sheets, prepared according to international accounting standards;
- terminating the cross-divisional payment guarantee system for raising loans;
- requiring affiliates to perform profitably, and merging or divesting those that are not profitable;
- promoting partnerships between the *chaebol* and small and medium-sized enterprises;
- placing their personal wealth into their companies to improve their equity base.

This compact captured the essential reforms needed to rein in the *chaebol* and give more life to other elements in the Korean economy, particularly small and medium-sized enterprises. While the abuses have generally occurred within the ranks of the mid-sized *chaebol*, and the top five have generally been responsible in their behaviour, the top five chairmen nonetheless took responsibility for the practices of their colleagues in mid-sized *chaebol* and for having failed to take the lead in reform.

The key strategic weapon of the *chaebol*, and the factor that has enabled them to expand so rapidly, has been the lack of transparency in their accounting and shareholding details. Behind the veil of secrecy, owners and their senior managers have been able to manipulate profit and loss flows, channelling profits from one business into another to get it started or prop it up during downturns. This has been a powerful technique for entering new businesses, such as semiconductors—and when it worked it served the firms, and Korea, very well indeed.<sup>2</sup> But such a system can, and does, lead to abuses.<sup>3</sup> Even in the case of the top five *chaebol*, the lack of consolidated balance sheets has presented company presidents with too many temptations for unaccountable diversification and expansion.<sup>4</sup>

<sup>1</sup> For discussion of the general practices of the *chaebol*, and case histories, see, for example, Kang (1996).

<sup>2</sup> See Mathews and Cho (1998) for a discussion of the case of semiconductors.

<sup>3</sup> In the case of Hanbo, for example, funds raised to build the steel mill were being siphoned off to start new, unrelated businesses, as well as to bribe bank presidents, legislators, government officials and presidential aides into maintaining the flow of funds.

<sup>4</sup> Samsung, generally reckoned to be the best-managed company in Korea, berates itself for having entered the car industry, at the cost of losses that will last until well into the next century and draining profits from the company's successful operations such as semiconductors.

The complement to insisting on transparent accounting is the elimination of the practice whereby a *chaebol* affiliate can raise loans backed by the security, indeed the total repayment guarantee, of its associated affiliates. The practice of using affiliates to guarantee loans is to be outlawed eventually, with *chaebol* individually seeking to reduce the level of their guarantees as fast as possible.<sup>1</sup>

Requiring affiliate management to ensure the profitability of their businesses is code for extensive restructuring of *chaebol* operations. One after another, the top 30 *chaebol* have been making announcements to this effect.<sup>2</sup> These involve plans to sell off assets, to merge unprofitable businesses into others, and to abandon ambitious plans for diversification (as in Hyundai's announcement that it would give up plans to enter the steel industry). All the major *chaebol* put a freeze on their overseas expansion plans. The net effect of these initiatives, if indeed they are implemented as announced, will be to reduce debt-to-equity ratios and slim down the *chaebol*, making them leaner and more focused competitors.

Calls for a better relationship between the *chaebol* and small and medium-sized enterprises are intended to end *chaebol* predatory practices that have gone on far too long in Korea. *Chaebol* are being urged to find ways of encouraging small and medium-sized enterprise growth and participation in the economy, either by striking up alliances with selected firms or leaving other sectors of the economy free of *chaebol* influence. This is why Kim Dae-Jung also announced steps to boost funding, export support, and services for small and medium-sized enterprises that will bring them into a position of being able to compete with *chaebol* on their own terms.

These promise to be the most thoroughgoing reforms to *chaebol* structures and practices in a generation. And Kim Dae-Jung appears to have every intention of driving the changes through.<sup>3</sup> The days of huge investment rates are behind them. They are likely to continue to be formidable competitors in international markets, particularly in areas where they have built up considerable internal know-how, such as semiconductors, steel, and shipbuilding. But now they move into a long-anticipated 'consolidation' phase, after the frantic growth and diversification of the past three and a half decades.

## 6. Prospects for a new Korean model

It is only very rarely that one glimpses the complete overhaul of an entire national political economy. Yet this is what is being undertaken in Korea under the mantle of the IMF agreements and driven by the political reform credentials of the Kim Dae-Jung administration.<sup>4</sup> How can the new model, which is being established through the reforms to the financial, industrial and political structures in Korea, be expected to work? The first point to note is that, in spite of all the 'liberalisation' and 'deregulation' of the financial sector,

<sup>1</sup> On the other hand, a too sudden outlawing of the guarantees, as originally demanded, could tip some groups into unnecessary bankruptcy.

<sup>2</sup> The Hyosung group (Korea's 14th largest *chaebol*) was first off the mark, announcing major restructuring initiatives in March 1998, designed to reduce its debt-to-equity ratio to 2.0 by the year 2002.

<sup>3</sup> His enforcer is the formidable Park Tae-Joon, founder of the steel giant POSCO, and now a member of the National Assembly and chairman of the United Liberal Democrats, the coalition partner with Kim Dae-Jung's National Congress for New Politics.

<sup>4</sup> While political reform has not been the focus of analysis in this article, it too has been an essential part of the restructuring. President Kim achieved enormous moral authority in driving through the reform process, not just through his own personal history (involving several jail terms as a dissident and attempted assassinations) but through gestures such as releasing former presidents Roh Tae-Woo and Chun Doo-Hwan.

the Koreans have no intention of replacing their former highly interventionist model of development with an Anglo-American style non-interventionist economy based on unfettered market forces. While the new Korean model will have at its centre an economy which is much more open and transparent, it will be closely supervised and regulated, and the sources of corruption and excessive risk-taking, such as too close ties between the Bank of Korea, commercial banks and lesser *chaebol*, will be much reduced. If these reforms succeed, the 'renovated' Korean economy is likely to benefit in terms of competitiveness; moreover, it could have new sources of competitive advantage.

The first of these new sources of advantage would be the emergence of the *chaebol* as genuine 'industrial groups' or clusters, on the Japanese model of *keiretsu*. Thus the restructured top five *chaebol* could emerge each as a tightly knit group of firms involved in a range of industrial sectors, knitted together by common ownership of financial institutions such as insurance companies, securities firms and (part ownership in) retail and merchant banks. Each could specialise in certain industrial sectors, but each would span manufacturing and service firms, and would have at its core financial institutions that would eventually provide a first preference channel for future capital needs. Such a structure if it emerges would give the Korean economy great responsive and adaptive capacities.

The second feature of the new industrial structure is likely to be flourishing small and medium-sized firms, many of which would be based on new and advanced technologies—unfettered or unobstructed by the *chaebol*. The emergence of such firms has been choked off in the past by the concentrated power of the *chaebol*. In the future, *chaebol* will stand to benefit by entering into alliances with such small and medium-sized enterprises as they seek to span as many of the emerging technologies as possible.

The strength of the former Korean model lay in its power to coordinate investment, partly through the operation of a 'pilot agency' such as the Economic Planning Board, and partly through the state controls over the financial system. Both have now disappeared. The Economic Planning Board was abolished (or rather 'absorbed' within the Ministry of Finance and Economics) in the mid-1990s, in an excess of deregulatory zeal. But a pilot agency of this kind is widely missed in Korea, and discussions are proceeding as to what kind of institution might take its place.<sup>1</sup> Other East Asian successes, like Taiwan and Singapore, maintain their pilot agencies—the Council for Economic Planning and Development in Taiwan, and the Economic Development Board in Singapore—adapting them as needed to new circumstances but never abandoning their coordinating and lead-taking role.<sup>2</sup> State controls over financial flows are unlikely to be reintroduced, but the vacuum created at the centre by the excess deregulation of the mid-1990s has been filled by the new financial supervisory structures.

Although these are early days, such signs of change lend plausibility to Korea's re-emergence as a strengthened and highly competitive economy. The new Korean model is likely to rely on accounting and financial transparency as devices to drive competitiveness and to extirpate any remnants of cronyism and corruption. This aspect of the new Korean model will be complemented by a greater reliance on the institutions of democracy in its supervision and its guidance. While Korea has made enormous advances in

<sup>1</sup> One of Kim Dae-Jung's initiatives is the creation of a new Office of Planning and Budget to be located in the Presidential Blue House, separate from the Ministry of Finance and Economics. This institutional innovation will go some way to redress the loss of coordination experienced with the demise of the EPB.

<sup>2</sup> The theoretical underpinnings of such structures are provided by Weiss (1995, 1998).

democratisation since the ending of the military regime in 1988, there is still much to be done to embed the processes of democracy in the institutional fabric of the country. This is precisely what the new Kim Dae-Jung regime is dedicated to accomplishing.<sup>1</sup> Extensive reforms are envisaged: a strengthening of the authority of the prime minister's office; a shift towards parliamentary authority and a reduction in direct presidential authority; a streamlining of the bureaucracy, and creation of new agencies such as the Office for Planning and Budget; a revitalisation of local government; a renewed mandate for trade unions to engage in political activities, thus inducting them as legitimate members of the Korean body politic. Kim Dae-Jung apparently has no intention of rescuing the economy and making it strong only to see it repossessed by an anti-democratic military and industrial elite.

Other analysts are less sanguine about Korea's prospects. Wade and Veneroso (1998) argue that Korea's highly leveraged development model needs strong government coordination if it is to work and that this is what is being dismantled at the insistence of the IMF (Wade and Veneroso, 1998). This analysis stems from a very pessimistic view of the role of the IMF. It does not seem to take into account the positive moves being made towards re-regulation currently under way within Korea. It is based on consideration of four ways of reducing a mountain of debt—through inflation, through declaring bankruptcy, through repayment of debt out of cash flow, and through debt-to-equity swaps. Wade and Veneroso see Korea as being precluded by the IMF from acting decisively on any one of these fronts. My disagreement with this analysis rests on two considerations. First, Korea has been able to use the IMF intervention to attack its debt problem directly, such as in the negotiated rollover of short-term loans and conversion of some of the short-term debt to longer-term securities. Second, the Wade and Veneroso 'solutions' such as inflation are oriented towards public sector debt of the Latin American kind in the 1980s, not to private sector debt of the East Asian 1990s kind. In Korea, the *chaebol* are restructuring in order to reduce their own debt-to-equity levels, thereby changing the debt structure of the country as a whole. Thus transformed, the firms will seek to trade their way out of their difficulties, and eventually retire the present debts.

The argument presented, then, is that while the 'East Asian Miracle' process in Korea expired in 1997, another process that might be called the 'rebuilding of institutional capabilities' is now under way. In some countries, such as Taiwan and Singapore, the institutions of the East Asian Miracle were sufficiently strong and resilient to enable the country to weather the storms of 1997 relatively unscathed. These countries did not succumb to rapid financial deregulation in the mid-1990s and did not abandon their governmental 'pilot' agencies that provided coordination and leadership in times of crisis. However, Korea has long been a country of greater extremes. It sought more rapidly accelerated growth rates; it indulged in higher investment rates and it relied more heavily on foreign debt to finance these investment rates than any other country. It thus ran bigger risks than others, and it therefore fell more heavily when the crunch came, as it did in November 1997. But Korea is also picking itself up more rapidly and re-establishing the institutional foundations for more balanced and more responsible growth in future. Where some profess to see in the events of 1997 and 1998 a definitive 'end' to East Asia's rise, and its Americanisation, this paper has argued instead that the crisis has seen a

<sup>1</sup> Many of the reforms have been canvassed by Kim in earlier speeches and writings; see Kim (1994) for a selection.

reinvention and reconsolidation of the institutional capacities needed to sustain a sophisticated and competitive economy.

To be sure, the 'new' Korean economy will have to ride out one or two very difficult years, in 1998 and 1999, while the full effects of the 1997 financial crisis work their way through. There will be many more bankruptcies of otherwise quite healthy companies; there will be layoffs and upheavals in the labour market; there will be further debt hiccups as the legacy of the past is only slowly dismantled. But these will represent the symptoms of the dying model, not those of the model in the making.

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